ROBERT W. BROWNLIE (Bar No. 138793)
robert.brownlie@dlapiper.com
JENNIFER M. FELDMAN (Bar No. 216645)
jennifer.feldman@dlapiper.com
DLA PIPER LLP (US)
401 B Street, Suite 1700
San Diego, CA 92101-4297
Tel: 619.699.2700
Fax: 619.699.2701

Attorneys for Defendants
SouthWest Water Company, Anton C. Garnier, Mark A. Swatek, Cheryl L. Clary, and Peter J. Moerbeek

UNITED STATES DISTRICT COURT

CENTRAL DISTRICT OF CALIFORNIA

ROBERT G. PERRIN and DIANE L. PERRIN, Individually and on Behalf of All Others Similarly Situated,

Plaintiffs,

v.

SOUTHWEST WATER COMPANY, *et al.*,

Defendants.

CASE NO. 2:08-cv-07844-JHN-AGRx

REPLY BRIEF IN SUPPORT OF MOTION TO DISMISS CONSOLIDATED AMENDED CLASS ACTION COMPLAINT

Date: May 17, 2010
Time: 2:00 p.m.
Judge: Hon. Jacqueline H. Nguyen
Courtroom: 790

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I. INTRODUCTION

Plaintiffs' Opposition to Defendants' Motion to Dismiss the Consolidated Amended Complaint (the "Opposition" or "Opp.") confirms that the Consolidated Amended Class Action Complaint (the "Complaint" or "CAC") does little more than block quote SouthWest Water Company's ("SWWC's" or the "Company's") filings with the Securities and Exchange Commission ("SEC") and press releases. Missing from the 189-page Complaint are *any* specific facts showing that at the time SWWC filed the reports with the SEC and issued the press releases that Plaintiffs claim were false, Anton C. Garnier ("Garnier"), Mark A. Swatek ("Swatek"), Cheryl L. Clary ("Clary") or Peter J. Moerbeek ("Moerbeek") knew — or were extremely reckless in not knowing — the financial information in those documents was false. Not a single internal report, witness statement or any other allegation shows what Garnier, Swatek, Clary or Moerbeek knew about SWWC's accounting, financial results or internal controls. Without alleging facts showing what those individuals knew, the Complaint cannot possibly allege with particularity that any of them intentionally made a false representation, which is required to plead scienter. For this reason alone, the Section 10(b) claim should be dismissed.

Defendants' Motion to Dismiss the Consolidated Amended Complaint (the "Motion" or "Mot.") also showed that the Complaint fails to identify with sufficient particularity the statements it claims are false and misleading or the reasons why each statement is false and misleading. Instead, the Complaint merely block quotes SWWC's public statements, leaving it to the reader to figure out which portions of the quoted material is alleged to be false. Moreover, the Complaint relies too heavily on the restatement to show that representations that were unaffected by the restatement were false. For these reasons as well, the Complaint should be dismissed.

II. THE COMPLAINT FAILS TO ADEQUATELY ALLEGE SCIENTER AS TO THE SECTION 10(b) CLAIM

Plaintiffs have failed to adequately allege facts giving rise to a strong inference that any of the Defendants acted with scienter.[1] Under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), Plaintiffs must "state with particularity facts giving rise to a strong inference" that defendants acted with an intent to deceive or with deliberate recklessness as to the possibility of misleading investors. 15 U.S.C. §78u-4(b)(2)(2010). Plaintiffs must plead, in great detail, facts demonstrating, at a minimum, a degree of recklessness that strongly suggests the required degree of intent. *In re Silicon Graphics, Inc., Sec. Litig.* 183 F.3d 970, 974 (9th Cir. 1999). Absent from the Complaint are any particularized allegations establishing that any of the Defendants acted with fraudulent intent.

The Opposition is peppered with the conclusory assertion that Defendants knew that their public statements regarding the accuracy of the Company's accounting and the adequacy of its internal controls were false or misleading. (Opp. 11:5-7; 19:16; 22:3-5.) These allegations fail to provide the requisite level of detail to allege that any of the Defendants acted with scienter. *See Silicon Graphics*, 183 F.3d at 985 (rejecting plaintiff's attempt to establish that defendant insiders had knowledge of alleged production and sales problems through general allegations that defendants had received internal reports where plaintiff failed to include "adequate corroborating details" regarding the internal reports to support the allegations); *see also In re The Vantive Corp. Sec. Litig.*, 283 F.3d 1079 (9th Cir. 2002) (finding that plaintiffs failed to plead scienter with particularity where

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[1] Plaintiffs also fail to adequately allege scienter as to their claim under Section 20A of the Securities and Exchange Act of 1934 ("Section 20A"). On a Section 20A claim, Plaintiffs must allege particularized facts giving rise to a strong inference of deliberate or conscious recklessness. *See Lipton v. Pathogenesis Corp.*, 284 F.3d 1027 (9th Cir. 2002) (the court affirmed the district court's dismissal of plaintiffs' Section 20A claim where allegations were insufficient to raise the requisite strong inference of deliberate recklessness as required by the PSLRA) (citing *Ronconi v. Larkin*, 253 F.3d 423 (9th Cir. 2001) (finding that well-timed sales do not support the strong inference of scienter required by the PSLRA)).

they relied on allegations of defendants' hands-on management style, their interactions with other corporate officers and employees, their attendance at management and board meetings, and receipt of reports generated by the finance department, but failed to allege corroborating details to support these allegations). The Complaint fails to allege the existence of any contemporaneous documents, internal reports, or witness statements that establish what any of the Defendants knew at the time of the public statements. *See Vantive*, 283 F.3d at 984; *Silicon Graphics*, 183 F.3d at 985. Thus, the Ninth Circuit has found that a complaint is properly dismissed where "[t]here is a total absence of factual allegations that would permit a strong inference that the defendants knew that their representations were false or misleading when made, if they were so, or that the defendants acted in deliberately reckless disregard of their truth or falsity." *Vantive*, 283 F.3d at 1089.

Eschewing particularized facts, the Complaint relies on a host of generalized allegations of stock sales, the magnitude of the restatement and the like in a failed attempt to plead scienter with particularity. While some courts have held that such allegations can *bolster* an inference of scienter, they cannot create a strong inference of scienter where no specific facts have been alleged showing what defendants knew or were deliberately reckless in not knowing. *See, e.g., In re Verisign, Inc. Deriv. Litig.*, 531 F. Supp. 2d 1173, 1207 (N.D. Cal. 2007) (finding that allegations regarding defendants' positions within the company, their sales of stock, and the fact of the restatement do not create a strong inference of scienter absent specific allegations of supporting contemporaneous reports or data establishing that defendants knew or were deliberately reckless in not knowing of the accounting errors that led to the restatement); *Rudolph v. UTStarcom*, 560 F. Supp. 2d 880 (N.D. Cal. 2008) (finding that restatement did not establish a strong inference of scienter absent factual allegations demonstrating that defendants knew specific facts at the time that rendered the accounting determinations fraudulent).

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Essentially admitting the Complaint does not include specific facts, Plaintiffs argue scienter may be inferred from reading the Complaint as a whole. (Opp. 6: 9-15.) While courts should certainly consider the complaint as a whole when determining whether scienter has been alleged,[2] particularity is still required. *See In re Sketchers U.S.A., Inc. Sec. Litig.*, No. 05-55980 F. Appx. 626, 2008 WL 1721557, at *1 (9th Cir. Apr. 10, 2008) (considering the allegations in their totality to determine whether plaintiffs stated with particularity facts giving rise to a strong inference of scienter). Indeed, the cases Plaintiffs rely upon are in accord. In *Backe*, the court found scienter was adequately alleged where the case involved a small company and reports of a confidential witness who had witnessed the fraudulent scheme in action. *Backe v. Novatel Wireless, Inc.*, 642 F. Supp. 2d 1169, 1191 (S.D. Cal. 2009). In *UTStarcom*, the court found scienter where the plaintiffs alleged a host of specific and particularized allegations demonstrating the defendants' knowledge of the falsity of the statements at issue. *In re UTStarcom*, 617 F. Supp. 2d at 976. In *Lattice*, the court found a strong inference of scienter was adequately alleged where there were allegations that defendants manipulated the financial statements. *In re Lattice Semiconductor Corp. Sec. Litig.*, No. 04-1255, 2006 U.S. Dist. LEXIS 262, at *18 (D. Or. Jan. 3, 2006). In contrast, here, Plaintiffs allege no specific facts showing that any of the challenged statements were made with actual knowledge, or consciously reckless disregard of, falsity. Thus, even if scienter could be inferred from the allegations taken together, the total of nothing plus nothing is nothing.

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[2] *South Ferry LP, No. 2 v. Killinger*, 542 F.3d 776, 784 (9th Cir. 2008); *Zucco Partners, LLC v. Digimarc Corp.*, 552 F.3d 981, 991 (9th Cir. 2009); *Metzler Inv. GMBH v. Corinthian Colleges, Inc.*, 540 F.3d 1049, 1069 (9th Cir. 2008).

A. The Restatement Does Not Give Rise to a Strong Inference of Scienter.

Plaintiffs claim the GAAP violations set forth in the Complaint support an inference of scienter because "books do not cook themselves." (Opp. 12:9.) This is not enough. For allegations of GAAP violations to raise an inference of scienter, they must be accompanied by particularized allegations of fraudulent intent. *In re Hansen Natural Corp. Sec. Litig.*, 527 F. Supp. 2d 1142, 1157 (C.D. Cal. 2007); *see also UTStarcom,* 560 F. Supp. 2d at 889 (holding that to establish fraudulent intent based on GAAP violations, the court must find that: (1) specific accounting decisions were improper and (2) the defendants knew specific facts at the time that rendered their accounting determinations fraudulent). No factual allegations in the Complaint show that any of the individual Defendants played a role in the GAAP violations or internal control weaknesses that led to the restatement. Further, no factual allegations show that any of the Defendants knew or was deliberately reckless in not knowing that the statements at issue were false when made.

In re Microstrategy, Inc. Sec. Litig., 115 F. Supp. 2d 620 (E.D. Va. 2000), relied upon by Plaintiffs, is instructive. There, the court acknowledged that scienter "cannot be *strongly* inferred from bare allegations of a GAAP violation or a restatement of financials." *Microstrategy*, 115 F. Supp. 2d at 635 (emphasis in original). Such allegations may be probative on the issue of scienter, but they cannot alone raise the requisite strong inference. *Id.* at 639-40.

Plaintiffs further argue that the nature of the GAAP violations at issue, the magnitude of the restatement and that the accounting errors were largely in SWWC's favor is enough to raise a strong inference of scienter. (Opp. 12:15-14:15.) However, the premise of Plaintiffs' argument is flawed. A number of the accounting errors that were restated were not in SWWC's favor. In other words, the numbers became more favorable to SWWC *as a result of* the restatement. For example, the restatement adjustments to the consolidated statement of operations

for the year ended December 31, 2007 included: (1) a decrease in operations and maintenance expenses of nearly $2.5 million; (2) a decrease in impairment charges to goodwill and other long-lived assets from $17.215 million to $1.768 million, one-tenth of the originally stated value; (3) an increase in operating income of more than 500% from $2.859 million to $15.309 million; (4) an increase in net income from negative $8.046 million to a positive $1.589 million; and (5) an increase in earnings per common share from negative $0.33 to positive $0.06. *See* Exhibit A to Declaration of Jennifer M. Feldman in Support of Reply Brief in Support of Motion for Partial Summary Judgment ("Feldman Decl.").

Thus, even if Plaintiffs' arguments had merit, the actual facts do not support Plaintiffs' contention. Indeed, to the extent accounting errors that are uniformly in favor of the defendant can raise an inference of fraud, the errors here, which as shown above went in both directions, must then defeat an inference of scienter.

B. The Complaint Lumps Defendants Together in a Failed Attempt to Conceal the Lack of Particularized Factual Allegations to Establish a Strong Inference of Scienter.

The Opposition fails to show that scienter has been alleged for each of the Defendants with the requisite particularity, as they are required to do. *See In re Cylink Sec. Litig.*, 178 F. Supp. 2d 1077, 1087 (N.D. Cal. 2001) (the "PSLRA requires plaintiffs to plead facts specific to the knowledge of *each* defendant") (citing 15 USC §78u-4(b)(2) (emphasis added)); *Allison v. Brooktree Corp.*, 999 F. Supp. 1342, 1350-51 (S.D. Cal. 1998) (the PSLRA requires "that the complaint set forth as to 'each statement' particular facts giving rise to a strong inference of scienter as to *each* defendant.") (emphasis added). The Opposition cites a handful of allegations in the Complaint which reference individual Defendants. (Opp. 24: 13-14.) None of these allegations, however, show that any of the individual Defendants knew or was reckless in not knowing that the statements at issue were false when made.

In an apparent attempt to back peddle from the Complaint's allegations, Plaintiffs argue that they are not seeking to impose liability against individuals based on statements they did not make or for which they are not responsible. (Opp. 24: 18-20.) However, the actual allegations are to the contrary. The Complaint includes a series of allegations in which Plaintiffs seek to hold all Defendants liable as a group for statements that are plainly on the face of the Complaint not attributed to all of the Defendants. (*See, e.g.*, CAC ¶ 33.) The practice of lumping all of the defendants into a group and treating them as a single wrongdoing monolith has long been held to not meet the requirements of particularity. *See Bruns II v. Ledbetter*, 583 F. Supp. 1050, 1052 (S.D. Cal. 1984).

Moreover, Plaintiffs even resort to the group-published information doctrine, under the misguided assumption that this doctrine relieves them of their burden to plead scienter. The group-published information doctrine, however, did not survive the PSLRA and cannot be used to raise a strong inference of scienter. *In re Impac Mortg. Holdings Sec. Litig.*, 554 F. Supp. 2d 1083, 1092 (C.D. Cal. 2008); *see also In re Ligand Pharm., Inc. Sec. Litig.*, No. 04cv-1620, 2005 WL 2461151, at *15 (S.D. Cal. Sept. 27, 2005) (group pleading allegations are insufficient to "raise an inference of scienter").

C. Sarbanes-Oxley Certifications Do Not Give Rise to a Strong Inference of Scienter.

The Opposition makes the bald assertion that Defendants Clary, Garnier and Swatek signed Sarbanes-Oxley ("SOX") certifications when they knew or were deliberately reckless in not knowing that they were false. (Opp. 19: 9-11.) No facts are alleged to support this claim. Moreover, Plaintiffs' reliance on the SOX certifications to raise a strong inference of scienter is flawed.

While Section 10(b) and Rule 10b-5 prohibit the making of false or misleading statements or the failure to disclose information necessary to make a statement made not misleading, Section 10(b) and Rule 10b-5 do not "provide

investors with broad insurance against market losses . . . ." *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336, 345 (2005). In securities cases, courts carefully scrutinize claims asserted by plaintiffs "to diminish the possibility that 'a plaintiff with a largely groundless claim [will be able] to simply take up the time of a number of other people [by extensive discovery], with the right to do so representing an *In terrorem* increment of the settlement value, rather than a reasonably founded hope that the process will reveal relevant evidence . . . .'" *Ross v. A.H. Robins Co., Inc.*, 607 F.2d 545, 557 (2d Cir. 1979), *cert. denied*, 446 U.S. 946 (1980) (citations omitted); *accord Semegen v. Weidner*, 780 F.2d 727, 731 (9th Cir. 1985).

"Congress by § 10(b) did not seek to regulate transactions which constitute no more than internal corporate mismanagement." *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 479 (1977) (quoting *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 12 (1971)). Consequently, allegations of mismanagement cannot support a claim under Section 10(b) or Rule 10b-5. *See id.* Not only are mismanagement claims outside the scope of Section 10(b) and Rule 10b-5, a plaintiff cannot "'bootstrap' allegations of fraud by asserting that a defendant failed to disclose corporate mismanagement or a breach of fiduciary duty." *In re First Chicago Corp. Sec. Litig.*, 769 F. Supp. 1444, 1449 (N.D. Ill. 1991) (citing *Panter v. Marshall Field & Co.*, 646 F.2d 271, 288 (7th Cir. 1981), *cert. denied*, 454 U.S. 1092 (1981)); *see also Craftmatic Sec. Litig. v. Kratsow*, 890 F.2d 628, 640 (3d Cir. 1990) (upholding dismissal of alleged failures to disclose mismanagement); *Andropolis v. Red Robin Gourmet Burgers, Inc.*, 505 F. Supp. 2d 662, 683 (D. Colo. 2007) ("Plaintiff may not bootstrap his internal mismanagement claim into a federal securities action."); *Shields v. Amoskeag Bank Shares, Inc.*, 766 F. Supp. 32, 36 (D.N.H. 1991) ("[T]he failure to disclose mismanagement is not actionable under Rule 10b-5.").

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Further, courts have held that a claim based on a failure to disclose inadequate internal controls also constitutes an improper attempt to bootstrap a mismanagement claim into a federal securities claim. *See Andropolis*, 505 F. Supp. 2d at 683; *In re Interpool, Inc. Sec. Litig.*, No. Civ. 04-321, 2005 WL 2000237, at *19 n.11 (D.N.J. Aug. 17, 2005); *Cutsforth v. Renschler*, 235 F. Supp. 2d 1216, 1243 (M.D. Fla. 2002); *In re United Telecomms., Inc. Sec. Litig.*, 781 F. Supp. 696, 699-700 (D. Kan. 1991). However, where a defendant has made an affirmative representation about the quality of its internal controls, a securities claim could be stated for failing to disclose inadequate internal controls. *See Shapiro v. UJB Fin. Corp.*, 964 F.2d 272, 282-83 (3d. Cir.), *cert. denied*, *UJB Fin. Corp. v. Shapiro*, 506 U.S. 934 (1992) (alleging that defendants represented "internal controls not only existed, but were properly centralized, supervised, and managed."). This holding flows from Rule 10b-5, which imposes a duty to disclose all facts necessary to make an affirmative representation not misleading. 17 C.F.R. § 240.10b-5(b) (2010). No such duty exists where there has been no representation about the quality of internal controls. *See Brody v. Transitional Hosps. Corp.*, 280 F.3d 997, 1006 (9th Cir. 2002).

The duty to disclose all facts necessary to make a representation not misleading is limited because Rule 10b-5 prohibits "*only* misleading and untrue statements, not statements that are incomplete." *Id.* A "statement will not mislead even if it is incomplete or does not include all relevant facts." *Id.* Thus, to be misleading for failing to disclose a fact, a statement must "affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." *Id.* Consequently, courts have held that merely disclosing the existence of internal controls without describing the adequacy of the controls does not give rise to a duty to disclose that controls were inadequate. *See Impac Mortgage Holdings*, 554 F. Supp. 2d at 1091 n.6; *In re Marion Merrell Dow Inc., Sec. Litig. II*, No. 93-0251, 1994 WL 396187, at *7 n.12 (W.D. Mo. Jul. 18, 1994).

Impac Mortgage Holdings, is instructive. There, the plaintiffs alleged that defendants signed SOX certifications certifying that they "had 'designed such disclosure controls and procedures . . . to ensure that material information relating to the registrant . . . is made known to us by others within those entities . . . .'" *Impac Mortgage Holdings*, 554 F. Supp. 2d at 1091 n.6. The plaintiffs argued "that this statement is an assertion that 'the Company's internal controls were adequate and reasonably effective' and therefore also qualifies as a false statement." *Id.* The court disagreed. The court explained that the statement meant what it said; *i.e.* "the officers designed disclosure controls and procedures that ensured material information relating to Impac would be known to them" and, consequently, the statement did not include any express or implied representation about the quality of those controls. *Id.*

Here, Plaintiffs' argument is premised on the flawed assumption that the restatement contradicts the certifications. Plaintiffs provide a misleading partial quote from the certifications at issue. The relevant portion of the certifications, as partially quoted by Plaintiffs, state that the signatories:

> []. . . have disclosed, based on our most recent evaluation of internal control over financial reporting, *to the registrant's auditors and the audit committee* of the registrant's board of directors: (a) all significant deficiencies and material weakness in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

See Exhibit B to Feldman Decl. (emphasis added). The certifications refer to a separate portion of the SEC filings, a document entitled *Controls and Disclosures*. The relevant portion of the *Controls and Disclosures* document is cited in the Complaint as follows:

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> Under the supervisions and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b) . . . Based on that evaluation . . . [we] have concluded that these disclosure controls and procedures are effective.

(CAC ¶¶ 282, 298, 309, 321, 335, 345, 354, 363, 376, 388, 399.) Contrary to Plaintiffs' assertion, the signatories did not certify that all internal control weaknesses had been disclosed to the market or the SEC filing; they certified that all such weaknesses, if any, were disclosed *to the Company's auditor and Audit Committee*. The certifications also do not say whether the controls were adequate or inadequate, worked well or not, or whether there was a disclosure of any or many "significant deficiencies" or "material weaknesses." Thus, just as in *Impac Mortgage Holdings*, the certifications make no representations about the quality of SWWC's internal controls.

Because the certifications make no representations about the quality of the controls, the certifications did not give rise to any duty to disclose whether SWWC's controls were adequate or inadequate. *See Brody*, 280 F.3d at 1006. While the certifications may have been incomplete as a result of not discussing the quality of the controls, they did not "affirmatively create an impression of a state of affairs that differs in a material way from the one that actually exists." *See id.* Consequently, the certifications did not give rise to a duty to disclose. Without a duty to disclose, Defendants cannot, as a matter of law, be liable under Section 10(b) or Rule 10b-5 for failing to disclose whether SWWC's internal controls were adequate. *See id.; Andropolis*, 505 F. Supp. 2d at 683; *Interpool, Inc.*, 2005 WL 2000237, at *19 n.11; *Cutsforth*, 235 F. Supp. 2d at 1243; *United Telecomms.*, 781 F. Supp. at 699-700.

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Moreover, nothing in the restatement or the Complaint suggests that, at the time the certifications were signed, the signatories were aware of any material internal control weaknesses or, if they were, that they did not disclose them to the Company's auditor or Audit Committee.

The Opposition also erroneously argues that the signatories certified that all internal controls were effective. (Opp. 19: 14-15.) The *Controls and Disclosures* portion of the SEC filings states that all "disclosure controls and procedures are effective" – not all internal controls over financial reporting. (*See* CAC ¶¶ 282, 298, 309, 321, 335, 345, 354, 363, 376, 388, 399.) Nowhere in the certifications do the signatories attest that the internal controls were effective, only that any material weaknesses or fraud in those controls had been disclosed to the Company's auditor or Audit Committee. Any portion of the certifications related to disclosure controls and procedures cannot be rendered false by the restatement, as all of the control issues identified in the restatement concerned "internal controls over financial reporting" as distinguished from "disclosure controls." *Compare* Exchange Act Rules 13a-15(f) and 15d-(f) (defining former) *with* Exchange Act Rules 13a-15(e) and 15d-15(e) (defining latter).

Signing certifications was a neutral act and cannot support an inference of scienter absent particularized allegations of fraudulent intent. *See Yourish v. Cal. Amplifier*, 191 F.3d 983, 993 (9th Cir. 1999) (plaintiff must do more than allege a set of neutral facts). Plaintiffs' authority is in accord. In *Glazer v. Capital Mgmt., LP v. Magistri*, 549 F.3d 736 (9th Cir. 2008), the Court held that a SOX certification was not indicative of scienter where the plaintiff failed to plead factual allegations demonstrating that the defendant was severely reckless in certifying the accuracy of the financial statements. *Glazer*, 549 F.3d at 747. In *Lattice Semiconductor*, the Court found a strong inference of scienter was raised, but did so

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based on an analysis of SOX certifications in combination with a mass of allegations establishing that the defendants in that case were severely reckless in signing those certifications. *Lattice Semiconductor*, 2005 WL 538756, at *17-18.

Finally, Plaintiffs contend that the certifications would be rendered meaningless if the officers who signed them did not believe they were accurate. (Opp. 19: 6-8.) Fair enough. However, the PSLRA requires that specific *facts* must be alleged to show at least deliberate recklessness, and those facts are not alleged here. 15 U.S.C. §78u-4(b)(2) (2010). There is a complete absence of facts indicating that any of the signatories to the SOX certifications at issue knew or were deliberately reckless in not knowing those certifications were false *when made*. *See Vantive*, 283 F.3d at 1085. Indeed, Plaintiffs' arguments constitute an improper attempt to plead fraud by hindsight by pointing to the restatement to argue that certifications signed months and years earlier were signed with knowledge of the subsequently discovered accounting errors and material internal control weaknesses. *See id.* at 1084-85 (the purpose of the PSLRA's heightened pleading requirements was to put an end to the practice of pleading "fraud by hindsight"); *see also In re Daou Systems, Inc.*, 411 F.3d 1006, 1021 (9th Cir. 2005). Thus, the SOX certifications do not support an inference of scienter.

D. The Opposition Fails to Demonstrate that the Alleged "Red Flags" of Internal Financial Control Weaknesses Give Rise to a Strong Inference of Scienter.

Plaintiffs argue that the material internal control weaknesses disclosed in the restatement support an inference of scienter because Defendants were somehow aware of the weaknesses due to certain "red flags" yet failed to correct them. (Opp. 16: 5-9.) As with Plaintiffs' other arguments, this argument is flawed because they have alleged no particularized facts showing that any Defendant understood that the material internal control deficiencies existed. Absent particularized facts showing that Defendants knew of the internal control deficiencies or were deliberately reckless in not knowing, Plaintiffs' allegations regarding internal control

weaknesses do not create an inference of scienter. *See Hansen*, 527 F. Supp. 2d at 1158; *In re Hypercom Corp. Sec. Litig.*, 2006 WL 1836181, at *9 (D. Ariz. July 5, 2006).[3]

E. Neither the Confidential Witness Allegations Nor the Core Business Doctrine Support a Strong Inference of Scienter.

The Opposition fails to show that either the confidential witness allegations or the core business doctrine supports a strong inference of scienter. Plaintiffs claim that CW1 is described with sufficient particularity to establish his reliability and personal knowledge and that his statements are indicative of scienter. (Opp. 20:20-23.) Neither an accountant nor a financial statement auditor, CW1 is not in a position to know the information alleged and, thus, is unreliable. *Zucco Partners*, 552 F.3d at 996 (finding confidential witness was not reliable where he was not positioned to know the information alleged). The Opposition, by its silence, does not dispute that CW1 is not qualified to provide a professional opinion as to whether SWWC would pass an audit. Indeed, SWWC *did* pass audits for each year during the class period.

Even if CW1 is reliable as a confidential witness, which Defendants do not concede, the statements reported by CW1 are not indicative of scienter and, thus, cannot be relied upon to raise an inference of scienter. *Zucco*, 552 F.3d at 995. The observations and opinions of CW1 do not provide any information regarding the mental state of any of the Defendants at any time. Indeed, CW1 did not become a consultant to the Company until April 2008. He cannot provide any information regarding the mental state of any of the Defendants before that time.

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[3] Plaintiffs' contention that Swatek's discussion of the need to improve SWWC's billing and financial reporting systems (CAC ¶420) does not support an inference of scienter. Indeed, if those statements show anything, it would be the opposite of scienter. If Swatek was attempting to conceal a so-called fraud concerning the adequacy of SWWC's internal controls or financial reporting, why would he be discussing it in public? *See Thornton v. Micrografx, Inc.*, 878 F. Supp. 931, 938 (N.D. Tex. 1995) ("Plaintiffs draw inferences of wrongdoing based upon a nonsensical premise."); *cf. In re McKesson HBOC, Inc. Sec. Litig.*, 126 F. Supp. 2d 1248, 1269 (N.D. Cal. 2000) ("courts do not presume that corporate officers make false statements simply out of spite or to impress others.").

Plaintiffs continue to rely on the "core operations" doctrine to support a strong inference of scienter. (Opp. 12: 15-18.) That doctrine, absent particularized supporting allegations, does not raise a strong inference of scienter. (Mot. 20:12-17.) The Opposition's reliance on *Batwin* is misplaced. In *Batwin*, the plaintiffs alleged detailed facts showing that the defendants had considerable involvement with the accounting function at issue. *Batwin v. Occam Networks, Inc.*, No. CV 07-2750, 2008 WL 2676364, at *12 (C.D. Cal. July 1, 2008). In contrast, here, there are no allegations that any of the Defendants had involvement, let alone considerable involvement, with the accounting functions at issue. Where, as here, the Complaint does not plead specific facts about what the Defendants knew at the time their statements were made, a strong inference of scienter cannot be presumed based on the core operations doctrine. *See South Ferry LP*, 542 F.3d at 784-85 (a complaint that relies solely on allegations of the core operations inference to establish scienter will generally fall short of the PSLRA's standard for pleading particularized factual allegations giving rise to a strong inference of scienter); *see also In re Apple Computer, Inc.*, 127 Fed. App. 296, 300 (9th Cir. 2005) (citing *In re Read-Rite Corp. Sec. Litig.*, 335 F.3d 843, 848-49 (9th Cir. 2003).

F. Plaintiffs' Motive Allegations Are Insufficient to Establish Scienter.

Plaintiffs rely on allegations of both incentive compensation and stock sales to establish Defendants' motive to commit fraud, but the Opposition fails to show that either of these categories of allegations raises a strong inference of scienter.

The Opposition claims that Defendant Garnier's compensation was tied to the Company's financial performance in such a way that supports an inference of scienter. (Opp. 22: 16-20.) However, allegations of bonus incentives tied to financial performance and incentive compensation in general are insufficient to raise a strong inference of scienter. *See In re Cornerstone Propane Partners, L.P. Sec. Litig.*, 981 F. Supp. 2d 1069, 1091 (N.D. Cal. 2005). Thus, as a matter of law,

Plaintiffs' allegations regarding Defendant Garnier's incentive compensation cannot support an inference of scienter.

While Plaintiffs argue that Defendants Garnier and Moerbeek sold stock on suspicious dates and that such sales were dramatically inconsistent with their pre-class period trading (Opp. 23: 6-8), they have failed to provide any *facts* to support that argument. Plaintiffs have the burden to demonstrate that these stock sales are unusual or suspicious, and they have failed to do so. *See In re Ashworth, Inc. Sec. Litig.*, No. 99CV0121, 2000 WL 33176041, at *10 (S.D. Cal. July 18, 2000).

Indeed, the alleged stock sales on their face indicate nothing suspicious. The allegations show that Defendants Garnier, Moerbeek and Clary sold roughly the same amounts of stock at regular intervals. (CAC ¶ 461.) Rather than raising any suspicions, this pattern of trading is consistent with a systematic diversification strategy, having nothing to do with an attempt to capitalize on an alleged fraud. *See Hansen*, 527 F. Supp. 2d at 1160 (court found stock sales were not suspicious so as to raise a strong inference of scienter where plaintiffs failed to link any of the stock sales to the alleged misstatements and neither the timing nor the prior trading history indicated that these sales were at "times calculated to maximize the personal benefit from undisclosed information.") This pattern of divestiture is unlike the trading patterns that courts found were suspicious in the cases relied upon by Plaintiffs.[4]

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[4] In *Secure*, the Court found that stock sales allegations supported a strong inference of scienter based on the timing and coordination of the sales. *In re Secure Computing Corp.*, 184 F. Supp. 2d 980, 989-90 (N.D. Cal. 2001). There, the defendants, none of whom had sold any stock previously, suddenly and in a condensed time period, sold over 200,000 shares - in many cases on the same days, and almost immediately after two defendants made statements at conferences that the company was on track to meet quarterly financial goals and immediately before the company released adverse financial information that led to drop in stock price. *Id*. In *SeeBeyond*, the Court found a strong inference of scienter where the amount of income generated by the alleged stock sales - $18 million – was significant and the defendant admittedly lied to the analysts and investors. *In re SeeBeyond Techs. Corp. Sec. Litig.*, 266 F. Supp. 2d 1150, 1169 (C.D. Cal. 2003).

Further, Plaintiffs wrongly attempt to discount the significance of the fact that the vast majority of the stock sales by Defendant Garnier were made pursuant to a 10b5-1 plan.

First, Plaintiffs feign ignorance as to the source of Defendant's claim that Defendant Garnier's sales were made pursuant to a 10b5-1 plan. (Opp. 23: 13-15.) Defendants' source for this information is the same source that Plaintiffs used to gather the information regarding the class period stock sales by Defendant Garnier – the Forms 4 filed by Garnier with the SEC.[5] To suggest they are unaware of the source of this information is disingenuous.

Second, Plaintiffs contend the 10b5-1 plan does not provide an absolute defense, at the pleading stage, to a claim of insider trading. (Opp. 23:15-19.) Courts have disagreed. Courts routinely analyze sales made pursuant to 10b5-1 trading plans in considering whether stock sales are suspicious for purposes of raising an inference of scienter. *See Weitschner v. Monterey Pasta Co.*, 294 F. Supp. 2d 1102, 1117 (N.D. Cal. 2003) (on motion to dismiss, court held that defendant's 10b5-1 trading plan could raise an inference that the stock sales were pre-scheduled and not suspicious); *Metzler Inv. GMBH*, 540 F.3d at 1067, n.11 (on motion to dismiss, court held that the bulk of defendant's sales took place according to pre-determined 10b5-1 plans and therefore were sufficient to rebut an inference of scienter.); *In re PMI Group, Inc. Sec. Litig.*, Nos. C 08-1405, C 08-1406, 2009 WL 1916934, at *10 (N.D. Cal. July 1, 2009) (on motion to dismiss, court found that majority of defendant's stock sales were pursuant to a 10b5-1 trading plan and thus sufficient to show that the stock sales were not suspicious). These cases show that Garnier's sales pursuant to his 10b5-1 plans were not suspicious for purposes of contributing to an inference of scienter.

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[5] *See* Exhibit C to the Feldman Decl., the Forms 4 reflecting Defendant Garnier's sales pursuant to a 10b5-1 plan. Under the incorporation by reference doctrine, these SEC filings are properly considered on a motion to dismiss, as Plaintiffs have relied extensively on these filings in the Complaint. *See Silicon Graphics*, 183 F.3d at 986.

Relying on *Nursing Home Pension Fund Local 144 v. Oracle Corp.*, 380 F.3d 1226 (9th Cir. 2004), the Opposition further argues that Defendants Moerbeek and Clary's lack of stock sales before the class period contributes to an inference of scienter. (Opp. 24:3-8.) *Oracle Corp.*, however, is inapposite. There, the court found that the lack of pre-class period stock sales *in combination* with the timing of the sales – just one month before the report of lower-than-expected sales – supported an inference of scienter. *Oracle Corp.*, 380 F.3d at 1231. Here, Moerbeek's last stock sale was on November 16, 2006, two years before the alleged fraud was revealed. (CAC ¶ 461.) Clary's last stock sale was on March 21, 2006, over two and half years before the so-called fraud was revealed. (CAC ¶ 461.) These sales bear no earmarks of an individual either seeking to capitalize on an artificially inflated stock or to dump his or her stock before the so-called truth was revealed. *See Vantive*, 283 F.3d at 1093 (finding stock sales were not suspicious in timing and were not calculated to maximize the personal benefit from undisclosed inside information where sales were over a year before the press release upon which the plaintiffs based their lawsuit). Thus, as a matter of law, the allegations that these Defendants had not sold stock before the class period, standing alone, do not raise a strong inference of scienter.

At bottom, whether examined individually or taken as a whole, Plaintiffs' allegations lack the necessary particularity to give rise to a strong inference of scienter and, for this reason alone, the Complaint should be dismissed.

III. THE COMPLAINT FAILS TO ADEQUATELY ALLEGE FALSITY

To adequately plead falsity, Plaintiffs were required to identify each specific statement alleged to have been misleading and the reason or reasons why each specific statement was misleading. 15 U.S.C. §78u-4(b)(1)(B). Plaintiffs have failed to do this.

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Plaintiffs have set forth a series of statements, using block quotes from the Company's SEC filings, press releases and conference calls, and peppered them with the identical laundry list of conclusory explanations for their falsity. (*See, e.g.* CAC ¶¶ 240-403.) This is not sufficient to establish falsity under the PSLRA. 15 U.S.C. §78u-4(b)(1)(B). First, Plaintiffs fail to specify the portions of the block quotes which Plaintiffs allege are false and misleading. Second, Plaintiffs fail to set forth the specific reasons why each statement was false when made. *In re Splash Tech. Holdings, Inc. Sec. Litig.*, 160 F. Supp. 2d 1059, 1072 (N.D. Cal. 2001).

The Complaint fails to identify precisely which statements within the block quotes are the statements Plaintiffs claim are false and misleading. The PSLRA requires that "the complaint shall specify each statement alleged to have been misleading." 15 U.S.C. §78u-4(b)(1)(B). Alleging lengthy block quotes fails to comply with this requirement. *See Cornerstone*, 981 F. Supp. 2d at 1080-81.

Plaintiffs rely exclusively on the restatement as an explanation of the falsity of the statements at issue, putting all their eggs in the same proverbial basket. The restatement, however, does not allow Plaintiffs to escape their burden of pleading falsity with particularity. The Complaint's allegations about the falsity of the statements at issue are nothing more than a comparison of the original financial statements with the restated financial information, done with the benefit of 20/20 hindsight. (*See* CAC ¶¶ 279, 333, 343, 352, 361, 373, 386, 397.)

As shown in the Motion, however, if the restatement establishes falsity of anything, it is only of the financial information which was restated. (Mot. 9:14-23.) Plaintiffs cannot rely on the restatement to establish the falsity of both the hard financial data that was restated and the soft information that was not restated. (*Id.*) Rather than provide a substantive response to this contention, Plaintiffs feign ignorance as to the distinction between "hard" financial information and "soft" information, even though they are virtually terms of art in securities litigation. *See,*

e.g., *In re Verifone Sec. Litig.*, 784 F. Supp. 1471, 1482 (N.D. Cal. 1992) (drawing distinction between hard and soft information for the purpose of analyzing disclosure obligations under the federal securities laws). Hard information includes hard data about a company's past financial performance; examples include consolidated financial statements. In contrast, soft information includes forecasts and predictions about a company's value and prospects, and is inherently imprecise in nature. *See* Bernard S. Sharfman, *Taking a More Sophisticated Approach to Market Efficiency: How Securities Analyst Reports Can be used to Establish Loss Causation in Federal Securities Fraud Action*, 38 SECURITIES REGULATION L. J. 3 (2010).[6] The allegedly false and misleading statements in the Complaint include both hard information (financial data from the Company's SEC filings), and soft information (non-financial statements in SEC filings, press releases and conference calls related to the company's performance).[7] The restatement can only be used to establish the falsity of the financial information that was restated. *See Verisign*, 531 F. Supp. 2d at 1204-05. Yet, the block-quoted statements in the Complaint go far beyond the restated financial results. (*See e.g.* ¶¶ 241, 269, 321, 363.)

Surprisingly, Plaintiffs concede they are not contending that any portion of the financial statements that was not restated was false or misleading. (Opp. 9:19-21.) As the restatement may be used to demonstrate the falsity only of the financial information that was restated, Plaintiffs have provided no explanation of the falsity of the remaining statements at issue, including non-financial information in the SEC filings, statements in press releases, and statements in conference calls with

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[6] A true and correct copy of Bernard S. Sharfman's *Taking a More Sophisticated Approach to Market Efficiency: How Securities Analyst Reports Can Be Used to Establish Loss Causation in Federal Securities Fraud Action*, 38 SECURITIES REGULATION L.J. 3 (2010) is attached as Exhibit D to the Feldman Decl. filed herewith.

[7] *See* examples of hard information at CAC ¶¶ 241, 253, 263, 276, 279. *See* examples of soft information at CAC ¶¶ 246, 248, 284, 293, 324.

analysts. Accordingly, Plaintiffs have failed to adequately allege falsity for the non-restated statements at issue in the Complaint.[8]

IV. CONTROL PERSON CLAIMS FAIL

Plaintiffs have failed to state a valid claim for violations of the federal securities laws, and thus, they have also failed to state a valid claim for control person liability under Section 15 or Section 20(a). *See, e.g., In re Syntex Corp. Sec. Litig.*, 855 F. Supp. 1086, 1098 (N.D. Cal. 1994), *aff'd*, 95 F.3d 922 (9th Cir. 1996).

V. CONCLUSION

For the reasons set forth above, Defendants respectfully request that the motion to dismiss be granted.

Dated: April 15, 2010

DLA PIPER LLP (US)

/s/ Robert W. Brownlie
Robert W. Brownlie
Jennifer M. Feldman
401 B Street, Suite 1700
San Diego, CA 92101-4297
Telephone: 619 699-2700
Facsimile: 619 699-2700

Attorneys for Defendants SouthWest Water Company, Anton C. Garnier, Mark A. Swatek, Cheryl L. Clary, and Peter J. Moerbeek

[8] As shown in the Motion, the entire Complaint sounds in fraud. Thus, Plaintiffs' failure to plead falsity with particularity should result in the dismissal of Plaintiffs' alleged Section 11 claim.